

Internal Revenue Service

Department of the Treasury

PERSON TO CONTACT:

EMPLOYER IDENTIFICATION NUMBER:

CONTACT TELEPHONE NUMBER:

IN REPLY REFER TO:

DATE: OCT 30 2000

CERTIFIED MAIL

Dear Applicant,

We have considered your application for recognition of exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code (Code) and have determined that you do not qualify for exemption under that section. Our reasons for this conclusion and the facts on which it is based are explained below.

You were incorporated in [REDACTED] as [REDACTED]. On [REDACTED] you filed Form 1023 with the Internal Revenue Service, requesting tax exemption under Code section 501(c)(3).

[REDACTED] is seeking foundation classification as an organization normally receiving support from gross investment income and more than one-third of its support from contributions, membership fees, and gross receipts from activities related to its exempt functions (subject to certain exceptions), as described in Code section 509(a)(2).

As provided in Form 1023, Part II, your activities and objectives include the following:

- The evaluation of a smoking cessation game with youth. The project was funded by the [REDACTED] through [REDACTED], a for-profit corporation.
- The evaluation of an on-line game, [REDACTED], for multiple players that teaches smoking cessation skills.
- The purpose of the corporation is to perform evaluations of educational and health related materials and to distribute multimedia and software products, for both private and public organizations.
- The evaluations of these materials will provide an unbiased and effective measurement for software companies and non-profit health organizations to make valid claims of the effectiveness of their products for the public good.
- The organization will also distribute these materials to for-profit and non-profit organizations that provide products for the public good.

The financial data provided in Form 1023, Part IV, and attachments reports total revenues of \$ [REDACTED] and \$ [REDACTED] for fiscal years ended [REDACTED] and [REDACTED] respectively.

The same financial data also reports salary expenses of \$ [REDACTED], \$ [REDACTED] and \$ [REDACTED] for the fiscal years referenced above.

[REDACTED] is also the [REDACTED] a for-profit corporation.

[REDACTED] are located at [REDACTED]. The property is described as a large Victorian style home owned by [REDACTED].

[REDACTED] entered into a Consulting Agreement with [REDACTED] on [REDACTED] [REDACTED] the Consultant agreed to perform specific services related to the testing of the smoking cessation software and on-line game developed by [REDACTED], the Company. The specific duties and services to be provided by the [REDACTED] were described in Appendix A and the compensation for said services were described in Appendix B.

The business plan, referred to as the "Plan", dated July 21, 1998 provides an overview of the organization and operation of [REDACTED]. The following information is taken from the Plan:

Mission Statement: "[REDACTED] will evaluate and distribute medical/educational software to physicians, nurses, patients and the general public."

"A total of \$ [REDACTED] is being sought for the distribution of [REDACTED] smoking cessation games. Youths at urban and minority schools will be targeted as recipients of these products. In addition, complementary nonprofit organizations will also receive these games. All products will be distributed by [REDACTED] for free." (emphasis added)

Medical Organizations and Consultants: Trained facilitators from [REDACTED] are currently conducting national efficacy trials of the Smoking Cessation/Prevention Games in conjunction with their program. They are in partnership with [REDACTED] and will be distributing the games.

Staff: Upon funding, [REDACTED] will hire two sales and marketing representatives, a [sic] two training medical educators.

Product Development: "Our product line will include medical/edutainment software games and kiosks."

"Our Smoking Cessation Games are interactive multimedia software. They are intended to be used in conjunction with programs, such as the [REDACTED] smoking cessation program, and as stand-alone games. "...The games run on IBM compatible computers and will be sold to youths, parents and medical and educational centers."

Distribution: Describes Federal and State Funded Agencies and their programs as well as the market potential for the organization's products.

Funding Requirements and Uses of Funding: Includes in part, \$ [REDACTED] salary for three telemarketing employees and Costs of Goods Sold of \$ [REDACTED] per unit.

Evaluation Charges for Health Educational Software Center Services Rendered: \$ [REDACTED] estimate (not specified as an annual amount, total for several years or some other period)

Law:

Code section 501(c)(3) provides for exemption from Federal income tax for organizations which are organized and operated exclusively for charitable, religious, and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Income Tax Regulations (Regs.) 1.501(c)(3)-1(a)(1) provides that in order to qualify for exemption under section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational or operational test will disqualify an organization from exemption under section 501(c)(3).

Regs. 1.501(c)(3)-1(b)(1) specifies that an organization is organized for one or more exempt purposes, if its Articles of Incorporation limit the purposes of such organization to exempt purposes.

Regs. 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish such purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Thus, in construing the meaning of the phrase "exclusively for educational purposes" in Better Business Bureau v. United States, 326 U.S. 279 (1945), the Supreme Court of the United States stated, "This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."

Regs. 1.501(c)(3)-1(d)(3)(i) defines educational as:

- (A) Instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (B) The instruction of the public on subjects useful to the individual and beneficial to the community.

Regs. 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated for any purpose under section 501(c)(3), unless it serves a public rather than a private interest. Thus to meet the requirements of this subparagraph, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests. Moreover, even though an organization may have exempt purposes, it will not be considered as operating exclusively for such purposes if more than an insubstantial part of its activities serve private interests.

While you are organized on a nonprofit basis and the member family associations are also organized on a non-profit basis, nonprofit is not the same as tax exempt. The fact that you do not make a profit is not the controlling factor. See United States v. La Societe Francaise de Bien, Mut., 152 F. 2d 243 (9th Cir. 1945), cert. denied 327 U.S. 793 (1946); Hassett v. Associated Hospital Service Corporation, 125 F. 2d 611 (1st Cir. 1942), cert. denied 316 U.S. 672 (1942); Baltimore Health and Welfare Fund v. Commissioner, 69 T. C. 554 (1978); and B. S. W. Group, Inc. v. Commissioner 352 (1978).

In Better Business Bureau v. United States, 326 U.S. 279-283, (1945), the court held that the existence of a single non-exempt purpose, if substantial in nature, would destroy exemption under section 501(c)(3) regardless of the number or importance of truly exempt purposes. To qualify for exemption under section 501(c)(3), the applicant organization must show (1) that it is organized and operated exclusively for religious or charitable purposes, (2) that no part of the net earnings inures to the benefit of a private individual or shareholder, and (3) that no substantial part of its activities consist of the dissemination of propaganda or otherwise attempting to influence legislation or engaging in political activity. See Kenner v. Commissioner, 313 F. 2d. 632, (7th Cir. 1963).

In general, an organization that applies for recognition of exemption has the burden of proving that it clearly meets all the requirements of the particular Code section under which it has applied. See Kenner v. Commissioner, 318 F. 2d 632 (7th Cir. 1963), and Cleveland Chiropractic College v. Commissioner, 312 F. 2d 203, 206, (8th Cir. 1963).

In Revenue Ruling 67-4, published in Cumulative Bulletin 1977-1, on page 121, the Service recognized four criteria indicating that publishing activities are directed to the attainment of purposes specified in section 501(c)(3). These criteria are: (1) The content of the publication must be "educational"; (2) The preparation of materials must follow methods generally accepted as "educational" in character; (3) The distribution of the materials must be necessary or valuable in achieving the organization's exempt purposes; and (4) The manner in which distribution is accomplished must be distinguishable from ordinary commercial publishing practices.

In analyzing the factors which distinguish whether an organization's activities are "sufficiently distinguishable from ordinary commercial practices" to qualify as carrying out an exempt purpose, the following factors are considered:

Whether a purpose is educational has been interpreted by the courts to be more than conveying information or providing instruction. The purpose must provide instruction or training, which is intended to enable the individual to improve and develop his capabilities or to instruct the public on subjects useful to the individual and beneficial to the community.

Regulations 1.501(c)(3)-1(c)(1) indicates that an organization will not be exempt under section 501(c)(3) if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Thus, an organization whose operations result in private benefits that is more than insubstantial will not be considered as serving an exempt purpose. This private benefit prohibition applies to all kinds of persons and groups, not just to "insiders" subject to the stricter inurement proscription.

Taxpayer's Position:

It is the position of [REDACTED] that its activities are charitable and educational in nature, because the smoking cessation games, computer software and kiosks, etc are designed to prevent and stop people from smoking cigarettes. [REDACTED] cites several software programs and games that have been formally approved by [REDACTED]

The Government's Position:

The evaluation and distribution of smoking cessation software and games, developed by the for-profit corporation controlled by the CEO of the applicant organization is not an exclusively charitable or educational with the meaning of Code section 501(c)(3). There is also a contradiction as to who is actually performing the product evaluation. In Form 1023, [REDACTED] states that it is evaluating the software and games. However, the business plan states the evaluation of these products is actually being conducted by representatives from the [REDACTED], who is also involved in the distribution of these products.

[REDACTED] has only one client, [REDACTED]. The activities of [REDACTED] are merely an extension of the activities conducted by [REDACTED]. [REDACTED] has formally approved all of [REDACTED] submissions. [REDACTED] has approved products developed by the for-profit entity, which is controlled by the CEO of [REDACTED].

The software and games may have some educational value with respect to smoking cessation and smoking prevention. However, these materials are developed and produced by [REDACTED], not [REDACTED].

Therefore, we have concluded that you do not qualify for exemption from Federal income tax as an organization described in section 501(c)(3) of the Code. In accordance with this determination, you are required to file Federal income tax returns on Form 1120.

Contributions to your organization are not deductible by donors under Code section 170(c)(2).

In accordance with the provisions of section 6104(c) of the Code, a copy of this letter will be sent to the appropriate State officials.

If you do not agree with our determination, you may request consideration of this matter by the Office of Regional Director of Appeals. To do this, you should file a written appeal as explained in the enclosed Publication 892. Your appeal should give the facts, law, and any other information to support your position. If you want a hearing, please request it when you file your appeal and you will be contacted to arrange a date. The hearing may be held at the regional office, or, if you request, at any mutually convenient district office. If someone who is not one of your principal officers will represent you, that person will need to file a power of attorney or tax information authorization with us.

[REDACTED]

If you do not appeal this determination within 30 days from the date of this letter, as explained in Publication 892, this letter will become our final determination in this matter. Further, if you do not appeal this determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust administrative remedies. Section 7428(b)(2) of the Code provides, in part, that "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

Appeals submitted which do not contain all the documentation required by Publication 892 will be returned for completion.

If you have any questions, please contact the person whose name and telephone phone number are shown in the heading of this letter.

Sincerely,

Steven T. Miller

Steven T. Miller
Director, Exempt Organizations

Enclosure: Publication 892

cc: [REDACTED]